

# **Foreign and Local Investment in East Africa: Interactions and Policy Implications**

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## **Abstract**

Existing economic literature shows that foreign direct investment (FDI) is a strong impetus to growth in trade, GDP and social welfare. What is less clear is whether domestic investment can take the lead? If so, it is cheaper and more politically popular to focus on stimulating it. This study used Granger causality tests to examine the relationships between foreign and domestic investment on a 110-country investment database, using both annual data and five-year averages for the period 1970 to 1996. Analysis showed that FDI has a strong impact on domestic investment. To the team's surprise, in developing countries there was no converse stimulation of foreign investment by spurts in domestic investment.

Three case studies, of Mauritius, Uganda and Kenya, demonstrated the intricacies of investor relations and investment policies on the ground. All three have officially had FDI promotion policies since independence. These were often not coherent with other policies, however. Each country has experienced periods when macro-economic policies and/or ethnic tensions counteracted investment incentives. The role of Asians as "invisible investors" in Ugandan and Kenyan investment policy is explored. Tensions over their role need to be resolved. The first step is enacting and enforcing more precise fair trade legislation, so that unfair practices by individuals can be eliminated instead of blaming a whole group. Then conscious efforts at outreach are needed on all sides.

The study concludes with recommendations for a holistic approach to investment policy. Investment incentives will only pay off once countries overcome their ethnic particularism, and ensure that the fundamentals that attract investors are in place, namely:

- Access to resources,
- Secure mobility of people, goods, information and capital into, around and out-of the country,
- Sound institutions—stable government, security of life and property, rule of law, viable financial services, and modern education and health systems,
- A proactive globalization policy, recognizing the importance of information technology, and
- Alertness to international opportunities and obstacles, as they appear.

These issues are of such broad scope that investment climate monitoring needs to be conducted at the top levels, both government and private. Investment promotion centers have little impact until such monitoring is established.

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## Introduction

Policy-makers throughout the world are devising strategies to attract a share of the new global capital flows, frequently in the form of foreign direct investment. Local business people are often ambivalent about their governments' courting foreign business, particularly in countries with fledgling private sectors recently liberated from statist economic management. Some fear that foreigners will take away business opportunities that locals might have had, or that foreign firms will have privileged access to capital and foreign exchange, reducing their own access. These are particularly acute questions in Africa today. The World Trade Organization is negotiating and implementing agreements designed to "create a level playing field." Those who have less access to capital, education, technology and market connections fear that they will not be able to compete.

This study was designed to explore whether foreign direct investment squeezes out locals, or conversely opens up opportunities for them. The team also hypothesized that local investment might sometimes take the lead, that an improvement in the business climate which stimulated local investment might act to attract FDI. McMillan examined these questions statistically using a worldwide forty-year database. Phillips, Obwona and Ayako conducted three case studies in Mauritius, Uganda and Kenya, to explore in more depth what these trends represented to actual firms and national economies. This study is part of a series of demand-driven policy studies aimed at maximizing growth and socioeconomic equity, funded under the United States Agency for International Development Equity and Growth through Economic Research/Trade Policy Cooperative Agreement (EAGER/Trade).<sup>1</sup>

The review of the literature showed agreement that investment is critical to the growth process and hence social welfare. The pressing question is, what kinds of investment are most beneficial and what are the most cost-effective and socially harmonious ways to stimulate investment?

Historically the overwhelming majority of investment in both developed and developing countries, has been and continues to be domestic. Yet many developing countries despair of stimulating local investment, pointing to national statistics showing very low domestic savings rates. This creates some problems and confusion in investment promotion programs. For example, FDI tends to be more expensive than local private investment because governments often make major concessions in order to compete for foreign investment. Programs designed to privilege foreign investors have frequently been tried. They generally provoke an outcry from domestic investors, who then succeed in having the same or better incentives extended to domestic investment.

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<sup>1</sup> The findings and views expressed here are those of the authors, and should not be attributed to USAID or the US government. We thank the many friends, officials and business people who so kindly assisted the team on this study, but they should not be blamed for opinions expressed here or for any errors.

The ethnic dimension frequently further complicates policy debates. Ethnic groups who have experienced colonization and discrimination in the past argue that affirmative action is needed to compensate, to provide them with a share of the national cake. There is resentment against both the colonizing country and immigrant commercial classes—Asians from the Indian subcontinent in East Africa, overseas Chinese in much of Asia, and middle easterners in other areas.

## **Review of the Literature**

Economic theory points to at least two distinct channels through which FDI may affect both private and public domestic investment in the recipient country. First, FDI often has an impact on the profitability of domestic investment. The impact is positive when foreign investors are directly involved in providing infrastructure such as transportation and telecommunications thus increasing the profitability of domestic investment, or when they transfer technology or create sectoral clusters of cooperating firms. In contrast, FDI may reduce domestic investor's earnings by taking market share away. This is particularly the case where investors are granted monopolies.

Secondly, FDI may alter the ownership structure of total investment in the host country and/or make domestic investment possible by providing additional funding. For example, a privatization sale to a foreign firm in itself has no impact on total investment but will release local funds for domestically financed investment. Sales are normally also contingent on substantial investment by the foreign buyer to modernize the firm. The findings of previous writers are summarized in Table 1 (Theory) and Table 2 (Empirical) below.

**Table 1:** Foreign Direct Investment and Domestic Capital Formation: The Theory

<b><u>Impact on Domestic Investment</u></b>	<b><u>Mechanism</u></b>	<b><u>Source(s)</u></b>
(+) Increase Profitability	♦ build infrastructure (roads, telecommunications etc.)	Cardoso & Dornbusch 1988
	♦ supply scarce inputs	Helleiner 1988
	♦ demand creation (local input suppliers, labor income, complements)	Cardoso & Dornbusch 1988
	♦ positive externalities (training, managerial skills, technology, access to overseas markets, market information)	Blomstrom 1989
	♦ additional tax revenue invested in public goods	Cardoso & Dornbusch 1988
(-) Reduce Profitability	♦ increase wages and/or cost of other locally supplied inputs	Lall & Streeten 1977
	♦ worsen terms of trade	Bhagwati, Brecher, Findlay 1981, 1983
	♦ stifle domestic competition	Helleiner 1988
	♦ negative externalities (tariff-jumping FDI, corruption)	Brecher & Diaz-Alejandro 1977
(0) New Financing	♦ new projects financed by FDI have no impact on existing domestic	Fry 1993
(-) Replacement Financing	♦ privatization and/or buyouts replace domestic with foreign	Fry 1993

**Table 2:** Foreign Direct Investment and Domestic Capital Formation: Empirical Evidence (1975 - present)<sup>1</sup>

Date	Author(s)	Data	Methodology	Results
1997	K.K. Mbekeani	South Africa Macro	2SLS Error Corr. Model	+
1997	Brian Aitken Ann Harrison	Venezuela Firm level data	Time Series Panel & Fixed Effects	+ Joint Venture - No local partner
1997	Maxwell Fry	46 country panel	Time Series Structural Model 3SLS	+
1993	Louis T. Wells	East Asia	Case Studies	+
1993	Wells & Warren	Indonesia	Case Study	+
1993/94	Maxwell Fry	Macro 16 countries 1966-88	Time Series Structural Model 3SLS	+ /- depends on policies in place <sup>2</sup>
1992	Katikati	Ghana	Time Series Granger Causality	-
1992	Faroque & Bougrine	Morocco	Structural Model Time Series	-
1989	Rhee & Belot	Asia & Africa Latin America	11 country case studies	+
1986	Encarnation & Wells	Asia	Case Studies	+/- depends on policies in place <sup>2</sup>
1977	Matos	Venezuela	Case Study	-

*Notes: (1) Prior to 1975, several studies were done on the impact of MNCs in Latin America. Most of these are case studies and it would be impossible to list all of them in this table. For a good summary of these see Grieco, 1986. (2) For example, Encarnation & Wells find that where FDI substitutes for imports because it is "tariff-jumping", the overall impact on the host country is negative.*

The theory of social capital also proved relevant to this study, as a context for analyzing ethnic aspects of investment. Early social capital writers suggested that organizations and social networks were a social good in themselves, reducing transaction

costs and improving productivity. Portes and Landholt (1996) argued that some organizations have negative aspects, as they seek to monopolize resources and/or political/military power.

Two related sub-themes emerged from the literature on social capital as it relates to factors in investment decisions, and were born out by our case studies: one was the negative impact of ethnic fragmentation per se on economic growth and the other was the importance of sound institutions in counteracting that negative influence. The negative impact of ethnic fragmentation as a variable accounted for one-third of the growth differential between East Asian and African economies between 1965 and 1990. (Easterly and Levine 1994) Ethnicity was in turn correlated with low school attainment, political instability, weak financial sectors, black market exchange rate premia, government deficits, inadequate infrastructure, lack of respect for property rights and inefficient bureaucracies, all of which negatively affect both growth and investment.

The institutional factors capable of neutralizing the negative effect of ethnic fragmentation include: (1) the rule of law, (2) the viability of the financial sector, and (3) the quality of educational institutions. We group under the rubric of “rule of law” such concerns as access to land, respect for private property, government intrusion or lack thereof in private business, fairness of the courts and the amount of street crime.

## Methodology

In addition to analysis of the existing literature, the study combined statistical analysis and case studies. For the statistical analysis Granger causality tests were performed on investment data from 110 countries. Using both annual data and five year

$$(9) \quad F_{it} = a_0 + \sum_{j=1}^4 \sum_{L=1}^m a_{Lj} R_j F_{it-L} + \sum_{j=1}^4 \sum_{L=1}^m b_{Lj} R_j P_{it-L} + \sum_{i=1}^n h_i cdum_i + \sum_{t=70}^{96} dum_t + u_{it}$$

averages for the period 1970 to 1996<sup>2</sup>, we estimated the following system of equations:

$$D_{it} = d_0 + \sum_{j=1}^4 \sum_{L=1}^m d_{Lj} R_j F_{it-L} + \sum_{j=1}^4 \sum_{L=1}^m g_{Lj} R_j P_{it-L} + \sum_{i=1}^n p_i cdum_i + \sum_{t=70}^{96} dum_t + v_{it}$$

where  $j$  denotes the region,  $m$  denotes the lag length and is chosen to ensure that the  $u_t$  and  $v_t$  are white noise error terms. The  $\alpha$ 's,  $\beta$ 's,  $\delta$ 's and  $\gamma$ 's are the coefficients of the linear projections of  $F$  and  $D$  on a constant and past values of  $F$  and  $D$ .  $F$  and  $D$  represent foreign and domestic investment and are computed as a percent of GDP.<sup>3</sup> Unobservable, time-invariant country characteristics are denoted by  $cdum$  and  $dum$  controls for year to year cyclical fluctuations.

<sup>2</sup> For some countries, data is available for a longer time period (Canada for example has data on both types of investment all the way back to 1948) but the majority of countries do not have data on FDI prior to 1970.

<sup>3</sup> This was done mostly out of concerns about stationarity of the time series data on investment measured in levels. Estimates of the dollar impact of investment today on future dollars of investment may be derived

For the case studies, the team adapted rapid appraisal techniques to firm-level interviews to assess investment climate issues in each of the three countries, and to get an initial overview of the experience of business and government leaders. A multidisciplinary team of senior researchers interviewed fifty to eighty firms and officials in each country. The team found that this approach added an invaluable qualitative dimension that could not be gleaned through data analysis or survey questionnaires. Qualitative assessments reveal historical elements, attitudes, values and beliefs that facilitate or hamper working relationships between different types of investors and government officials.

## **Findings**

The statistical analysis for the present study are summarized in Table 3 below. It found that foreign direct investment (FDI) does act as a catalyst for local private investment. A one percent increase in FDI as a percent of GDP is followed by 0.8% in Africa and as much as a 1.17 percent increase in future domestic investment as a percent of GDP in Latin America. For developing countries, the impact of lagged FDI on domestic investment is more than two times the impact of lagged domestic investment on domestic investment.

To the team's surprise there was no robust correlation in the opposite direction, no evidence that surges in domestic investment attracted FDI.

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using the following approximation,  $\partial d_t / \partial f_{t-1} = \delta (y_t / y_{t-1}) = \delta(1+g_t)$ , where  $g$  is growth of gdp,  $y$  is gdp and  $d$  and  $f$  are domestic and foreign investment.

**Table 3: Impact of a One Percent Increase in Lagged Investment on Current Investment by dependent variable/explanatory variable**

(All figures are % change in investment as a percent of GDP)		
<b>A. Does FDI ↑ total domestic investment?</b>	<b>short-run</b>	<b>long-run<sup>*</sup></b>
Africa	0.80	2.78
Asia	0.91	2.28
Latin America	1.17	2.19
OECD	0.54	no
<b>B. Does FDI ↑ private domestic investment?</b>	<b>short-run</b>	<b>long-run</b>
Africa	no	3.71
Asia	5.06	16.32
Latin America	1.01	2.52
OECD	no	no
<b>C. Does FDI ↑ public domestic investment?</b>	<b>short-run</b>	<b>long-run</b>
Africa	no	1.27
Asia	no	2.27
Latin America	no	1.04
OECD	no	no
<b>D. Does Total Domestic Investment ↑ FDI?</b>	<b>short-run</b>	<b>long-run</b>
Africa	no	no
Asia	no	no
Latin America	no	no
OECD	-.02	-0.12
<b>E. Does Private Domestic Investment ↑ FDI?</b>	<b>short-run</b>	<b>long-run</b>
Africa	no	-0.02
Asia	no	0.03
Latin America	0.46	-0.05
OECD	no	-0.21
<b>F. Does Public Domestic Investment ↑ FDI?</b>	<b>short-run</b>	<b>long-run</b>
Africa	no	no
Asia	-0.44	no
Latin America	-0.26	no
OECD	no	no

Sources: FDI is from International Monetary Fund (IMF) and United Nations Commission on Trade and Development. Series is Inward Direct Investment meaning that it does not include FDI by host country nationals in foreign countries. Investment is from IMF and series is gross fixed capital formation minus FDI. Private and public are from United Nations National Accounts. Short-run results based on annual data, long-run results based on 5-year averages and no means not significant at or above the 90% level.

Notes: "Short-run" refers to results obtained using annual data, and "long-run" refers to results obtained using five year averages. Point estimates reported in Table 3 are obtained from the tables in the appendix by adding the differential slope coefficient for each region to the coefficient on OECD. Only those estimates that are significant at or above the 90% level are reported in Table 3. Also, none of the results for the variables' own lag are reported in Table 3. This is because all four measures of investment are persistent in all regions as expected.

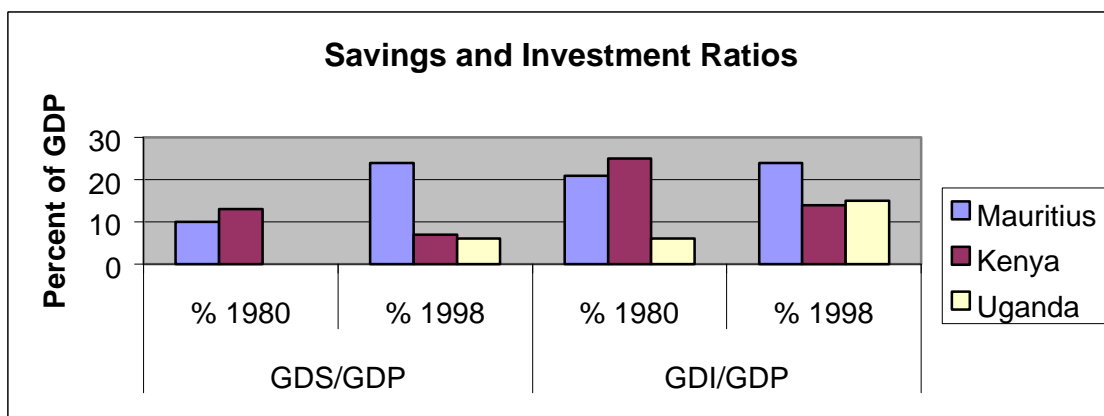
The statistical analysis in this study established that foreign investment takes the lead in stimulating domestic investment, and, more generally, economic growth. Those who argue that it squeezes out domestic investment are wrong as far as the big picture is concerned. FDI has squeezed out local investment mainly when it is conducted on a monopoly basis. These have not been statistically significant in any region of the globe.

## Case Studies

The case studies showed how and why FDI serves as a catalyst, and domestic investment alone does not. In countries, such as Mauritius, where foreign investment has been a strong stimulus to growth, domestic investors reported unanimously foreign investment was a good thing, as linkages with foreign investors allowed them to benefit as well. In fact, even in Uganda and Kenya, nearly all African business leaders interviewed favored foreign investment, and recognized that it offered them economic opportunities. The few policy-makers who still oppose foreign investment tend to be politicians, not business leaders, playing on nationalist or ethnic sentiments.

Mauritius was chosen as a case study country because of its reputation for having stimulated foreign investment and built a modern economy based on policies alone. No mineral resources were involved, and the beach resorts on which its tourism has flourished are no better than those available along mainland African coasts. The choice of Kenya and Uganda was based on demand by policy-makers, public and private, who are strongly motivated to make their countries competitive in the new global economy. Several other countries expressed interest, but could not be included because of time and budgetary limitations.

The three countries have had startlingly different economic paths. Kenya had the best economic growth in the first two decades of independence, while Uganda quickly fell into political and economic disarray. Mauritius got a late start, but surged ahead in the 1980s and 1990s as Kenya began to stagnate and decline. Uganda began an upturn in the 1990s, but has a heavy legacy to overcome. The three countries' savings and investment rates, charted in Figure 1 below, reflect the results of these vicissitudes.



## **Mauritius Case Study**

In the Mauritius case study the team found a firm-level understanding of why foreign investment takes the lead and produces so many positive repercussions. Mauritius is unique in having had a wealthy class of sugar plantation owners who were actively seeking to diversify their investments in the first years of independence. They have experimented with horticultural and industrial exports, as well as with tourist facilities, for many years.

For the first ten years after the export processing zone legislation was passed, it had little effect on overall investment. Foreign investors were hesitant about Mauritius in the 1970s because it had currency controls, protective tariffs, deficit spending and an uncertain political prognosis. These policies worked in contradiction to the avowed export promotion policy. In the early 1980s Mauritius voluntarily restructured its macroeconomic framework, removing currency controls and other hindrances. That, and its ability to change governments without reneging on commitments finally gave outsiders confidence.

It took the arrival of Hong Kong and Taiwan textile firms to get industrialization going. And South African hotel chains first brought the tourist facilities up to world-class standards. Why couldn't the wealthy Franco-Mauritians do it alone? The key missing ingredient was the much vaunted keystone of the "new economy:" knowledge. Mauritian investors lacked the depth and breadth of knowledge needed to create viable industry and tourism on their own.

The overseas Chinese and South African investors brought in-depth knowledge of how to run an efficient firm. They also had intimate knowledge of customers and their preferences, as well of what the competition was offering. They were able to train the Mauritian workforce, interspersing production lines with faster Chinese workers and more flexible Indian ones to bring up productivity. Domestic investors of all ethnic backgrounds unanimously reported that they were not squeezed out by foreign investment. On the contrary, they worked with, learned from, and in many cases bought out foreign investors.

Ethnicity has been handled delicately in Mauritius, in surprising contrast to analysts' predictions at independence. The few dozen Franco-Mauritian sugar families who controlled the economy at independence in 1968 faced the classic South African nightmare of being washed into the sea. The majority of the new electorate comprised landless descendants of cane-cutters brought in from the Indian subcontinent as contract labor. Yet Mauritians found a stable accommodation, in both politics and the economy. The constitution explicitly recognizes ethnic minorities, providing for 10 percent of parliamentary seats to go to "also rans" from ethnic minorities that would otherwise not be represented.

The tiny new polity attained in two decades an economic transition from mono-crop sugar island to a balanced economy in which textiles, tourism and sugar are the pillars. New forays are being made into off-shore business services, information technology and other diverse export products. Indo-Mauritians are still minimally represented as entrepreneurs, though they dominate the civil service. Sino-Mauritians, hitherto concentrated in small-scale commerce, enhanced their status through association with Hong Kong and Taiwan industrialists whose knowhow and investment initiated the textile sector. Economic tensions are worked out in annual tripartite negotiations between labor, government and employers, most of whom are Franco-Mauritians.

Sound institutions have played a critical role in the process. The rule of law has prevailed consistently. The sturdy financial sector, led by Mauritius State Bank since 1828, provides investment capital to both domestic and foreign investors. The British-tradition schools graduate fully bilingual, often tri- and quadrilingual students, whom employers find a great asset in the new global economy.

## **Uganda**

Uganda and Kenya have been less successful than Mauritius in attracting foreign investment. Despite formal policy platforms favoring foreign investment since independence, both countries have periodically indulged in the politics of ethnic rivalry which creates negative social capital. It makes for an ambiance that, in practice, has outweighed formal investment incentives. Moreover the sound institutions that might have counteracted this negative trend have eroded over the years, rather than developing.

The politics of investment promotion in both countries is complicated by the predominance of Asians from the Indian subcontinent as both foreign and domestic investors. Tensions built in East Africa throughout the years following independence, as it became clear that wrenching control of government from Britain had not brought with it control of the economy. Both Kenya and Uganda expropriated lands and firms of whites and Asians, and tried state capitalism in the 1960s and 70s. Alongside these acts official investment promotion policies appeared more and more incoherent. Idi Amin's regime in Uganda actually enacted an investment promotion law shortly before unleashing what are now known as the Economic Wars, attacks on Ugandan Indian commercial and industrial interests that drove them from their homes and businesses.

The military government of Idi Amin was overthrown in 1979. Although an elected government came into power in 1980, foreign investors remained wary of the country, mostly on account of past expropriations and continuing instability. Uganda's landlocked position, and high costs of transportation and energy were also factors. The ratio of FDI to gross fixed capital, was negative 0.2 between 1981 and 1985. (World Financial and Statistical Tables, 1995) In order to correct this bad image, a bill was presented to and passed by the parliament to return the properties of the foreign investors. However, it was not implemented until 1990 by a new government under the National Resistance Movement (NRM).

Economic recovery, and building a viable investment climate, has proved a complex and daunting task for Uganda. The Museveni government has taken critical steps that are recognized worldwide. It is credited with good macroeconomic performance (low inflation, high growth rates, convertible currency, etc.) and the creditworthiness (risk rating) has improved (Collier 1997). Political stability was restored in most of the country, and generous investment incentives enacted. The government is known for its commitment to private sector development. It has enacted a liberal foreign exchange regime, simplified import and export procedures, and removed restrictions on the movement of capital into and out of the country.

Linkages between foreign and local firms have created a strong pro investment opinion among Ugandan business people, who are often more open than their political leaders. The most important linkages reported allowed local firms to access technology, management, equity capital and training. Firms also indicated that linkages with foreign firms were beneficial in helping them gain access to export markets. Local sourcing has been more important for services than for parts and other inputs, although both parties are working to improve that situation.

Offering to return Asians' seized properties did bring many back, and the respect for private property that it reflected encouraged others. Returnees, however, have found high energy and transport costs make it difficult to compete, even for the import-substitution industries that still predominate. Other policy-related distortions that inhibit their competitiveness include currency overvaluation, high interest rates, and remaining tariffs on inputs. (Siggel and Ssemogerere 2000: 34) Initial investor interest is far stronger than actual investment, as the conversion rate of planned to implemented investments hovers around 40 percent.

Removing remaining policy distortions and rebuilding institutions in Uganda need to be high priorities. The legal system, the financial sector, schools and healthcare have all suffered through the years of civil conflict.

## **Kenya**

Kenya was chosen as a case study because of concern among private and public-sector policy-makers there that investment is falling off. Despite its much larger and well educated population, Kenya has domestic savings and investment rates similar to Uganda's in 1998 and far below those of Mauritius (see Figure 1 above). Kenya also shares with Uganda the primordial role of the "invisible investor." Most of Kenya's investors, both foreign and local, are of Indian descent. A recent analysis showed that from the colonial period through the 1980s, the percentage of firms owned by Kenya Indians varied from 71 percent to 85 percent, with European, African and other firms lagging far behind. (Himbara 1994) Yet foreign investment promotion efforts target Europe, and local business promotion efforts target Africans.

Kenya was a popular investment destination in the decade before and after independence in 1961. It experienced in the 1960s and 1970s:

- Average GDP growth of about 6.5% per year,
- Average GDP per capita growth of about 3% per year,
- Minimal inflation (less than 3% per annum), and
- Current account balanced with minimal external debt burden.

This situation was conducive to the first wave of foreign investment under the import substitution strategy. In 1980 it outranked Mauritius in both savings and investment. Since the 1980s, however, it has experienced macroeconomic instability, with negative GDP growth rates, rapid population growth, double-digit inflation, large current account imbalances and external indebtedness, all of which have been deterrents to foreign investment.

Africanization of the economy was attempted through several means under Kenyatta's government: creation of state corporations, repossession of white settler farms in the highlands, and forced Africanization of firms. The Trade Licensing Act of 1967 banned non-African merchants from all but central business districts. Over the next few years thousands of small-town dukawala owners in rural areas were forced to close or sell out. Many emigrated to the UK, India, Canada or the US. This struggle for control was more peaceful and less sweeping in Kenya than in Tanzania and Uganda. In the end it was no more successful nevertheless. The man then responsible for enforcing the Africanization policy of the 1970s, Mr. Sam Waruhiu, who by 1994 was chairman of Barclays Bank, commented looking back:

When the window was opened for African businessmen through the Trade Licensing Act, and various schemes such as the [Industrial and Commercial Development Corporation] ICDC at independence they had no experience. . . . The experiment was not only a major failure from the perspective of African businesses, it backfired in another respect. The Act forced the Indians into the more challenging section of the economy—manufacturing especially. After their largely successful movement into this sector, they came back, ironically, with a much larger base and reclaimed the retail and wholesale sector. (Interview with Himbara [1994, 61])

Shortly after the breakup of the East Africa Confederation, the current President Daniel arap Moi came to power in 1978, supported by a coalition of smaller ethnic groups that pointedly excluded the formerly dominant Kikuyu. The Kalenjin ethnic group from which the new President came, and his Masai allies were initially more interested in consolidating their positions in the state apparatus and civil service than in expropriating firms. The result was a more laissez-faire economy in Kenya beginning in the late 1970s.

Ironically, the Kikuyu and their allies, who had dominated in founding President Kenyatta's time, as they lost positions in the civil service, moved into the private sector. In this more complex new phase a few African manufacturers were able to get a start: 5 percent of the firms started in the 1980s were Kenyan African owned, and 6 percent of the total created over the whole period 1964-1990 were Kenyan African owned. (See Figure 8.6) Kenya European industrial investment had dried up by this time, and has not reappeared. Instead there was a surge of foreign/joint venture firms in the 1980s.

Freed by the Ndegwa Commission report in 1971 to combine business with civil servants, top civil servants held an interest in many “joint venture” corporations and used their offices to protect and advance their firms. In some key sectors both foreign and local investors hesitate for good reasons to try to compete with well connected firms, giving them de facto monopolies. The Ndegwa Commission Report has been discredited for having created widespread conflicts of interest, in effect 'legalising' corruption in the country. It is credited with generating little or no new manufacturing investment.

The investment wave of the 1980s dwindled in the 1990s, as the institutions that had protected both the economy and body politic from arbitrary intervention were eroded. In the last two decades, appeals to ethnic bases have become more overt in Kenyan politics and the economy. The groups in power are smaller in size, and have built fewer horizontally linked organizational bridges to other ethnic groups. The trend represents a reinforcement of negative social capital. International pressure to rectify this situation seems ironically to have intensified the problem, as it has focused on demands that Kenya open up its one-party political system to allow for an effective opposition. In the absence of horizontal bridging organizations of other types, the result has been to intensify appeals to ethnicity. Mistrust between groups has reached new levels, and means of building trust and intergroup cooperation are becoming thinner. Moreover, government policies of all sorts have moved into a logic that benefits the few at the expense of the larger society and economy. From the point of view of investors, the key negative trends have been:

- Inappropriate government spending, particularly allowing Kenya’s initially good infrastructure and the educational systems to decay,
- A high regulatory burden on business, diminishing its competitiveness,
- A high percentage of senior management’s time spent negotiating permits/licenses,
- Lack of enforcement of regulations (rule of law eroded),
- Prevalence of tax evasion, and
- Lack of perceived competence in the public sector.

Among donors new attention is being paid to programs designed to reinforce civil society by providing grants and training to the media and non-governmental organizations. In theory, stronger civil society will provide the necessary linkages that foster cooperation over the medium and long term. The timing may have been wrong enough to subvert the process, however. Once ethnic appeals have been allowed to permeate the multi-party political process, re-establishing trust and cooperation is a complex process.

Kenya’s most pressing challenge is restoring the institutions and infrastructure that buoyed its initial economic growth. General law enforcement, thus physical security of people and property, and judicial support for commercial contracts has worsened over time according to investors surveyed. New strict conflict-of-interest standards need to be established and enforced. Financial probity in both government and corporations needs to be re-established.

## **Summary of Conclusions and Recommendations**

### **1) FDI has a strong stimulus effect on domestic investment, and on economic growth.**

It is not, however, a panacea. Sequencing is all important. FDI cannot be courted effectively unless other policies and economic factors (summarized in point 4 below) put the country in a competitive position in the global economy.

### **2) Governments that focus on fostering linkages between foreign and domestic firms enhance the benefits to both.**

One of the best means of enhancing growth in domestic firms is to encourage domestic sourcing and subcontracting by both firms and government itself. This should start with removing obstacles and disincentives to local sourcing, such as duty-free agreements with major investors that exclude imports, but not locally sourced supplies, from import duties and VAT. A second common obstacle, at present, is slow payment of small contractors by government. Lack of liquidity caused by delayed payment can be a crushing burden for small contractors.

Fostering linkages can also be a means of affirmative action to enhance business opportunities for historically disadvantaged groups. The experience with quotas and required ownership percentages has been negative from the point of view of both investors and all but a few domestic business people. Fostering business opportunities, as contrasted with imposing them, requires a lighter hand by regulators. Government tenders already allow African-owned businesses a 10 percent cost advantage in bidding on government contracts in Uganda and Kenya. Investment agreements with large companies might require that they also extend this cost advantage. Uganda lets local investors qualify for investment incentives with lower capital and employment levels than for international investors. Kenya puts them on an equal footing, and focuses more on whether a firm plans to export than promises of capital and employment levels.

Another option for improving business opportunities for locals is working out voluntary plans whereby multinationals package procurement in small tenders, instead of mega-contracts that only other multinationals are capable of filling. Often multinationals are willing to work with local contractors as part of their social responsibility commitments if they can ensure that it does not diminish their own competitiveness in their core business. Local contractor training and contract supervision services programs exist in some countries to facilitate this process, by improving quality control and timeliness by local contractors.

### **3) The new global economy offers opportunities in that capital now flows quickly to interesting investment opportunities. On the other hand, the new economy is information based—and the information gap is growing. Countries that favor modern, cheap telecommunications and transport will have an advantage.**

All three case study countries have improved access to telecommunications in recent years, and reduced or removed import duties on computers. They have licensed mobile telecommunications, rapidly accelerating the number of subscribers. Subscriber costs have come down from previous astronomical levels. Rates are still, however, higher for a local call in any of the case study countries than for a long distance call anywhere in the US. International call rates have come down from around \$6 per minute to around \$2 per minute in the late 1990s, but that is still several times what firms in developed countries pay.

Telecommunications continues to be treated as a cash cow by governments and private companies. Autonomous national communications boards representing all stakeholders need to be empowered to tailor policies to the wider common good.

**4) A holistic approach to encouraging investment is needed. Investment incentives can be a waste if not combined with a sound economic environment. Investment policy has to take into account how each country compares on the five key factors:**

- Access to resources,
- Secure mobility of people, goods, information and capital into, around and out-of the country,
- Sound institutions—stable government, security of life and property, rule of law, viable financial services, and modern education and health systems,
- Economic characteristics of the location,
- Investment incentives and business facilitation, and
- The regional and international policy environment.

**5) Priorities and sequencing will be different for each country and sector, depending on how it measures up to the competition.**

In Kenya and Uganda the priorities need to be institution building, infrastructure, security and cost reductions. Within those categories there are nuances: in the security area, Kenya needs to focus on a high crime rate, while Uganda concentrates on making peace with rebels in the north and west. Each country will need to do its own institutional evaluation and reform plan.

The two countries need to focus together on rebuilding infrastructure, as Kenya port and road network serve both countries and Uganda's hydroelectricity could serve both.

Other cost reductions need to be realized in energy, transportation, telecommunications and remaining taxation on imported inputs.

Mauritius is doing well, but has lost its competitive edge in basic knitwear as it became a middle-income country. It needs to focus on more efficient bureaucratic procedures and reducing transportation costs.

All three countries have mostly got their macroeconomic framework close to right. Unfortunately that is not enough, as most of the rest of the world's countries have done likewise.

**6) Multilateral investment frameworks such as debated by the WTO will probably not help the three case study countries attract investment.**

Draft multilateral investment frameworks tell policy-makers what investors want, but not how to get their country there ahead of the rest.

**7) Fair trade legislation needs to be made more precise, and enforced impartially.**

In the absence of clear legislation defining unfair trade practices, and reliable court enforcement of penalties, unfair trade practices go unpunished. Blame tends to be generalized to ethnic groups responsible for such practices, instead of individuals and firms actually engaging in it. This is a very important step in improving ethnic understanding.

**8) Politicians and business people need to explore the positive and negative social capital theory together. They need to focus on the role of sound institutions in overcoming ethnic fragmentation.**

Participation in professional and voluntary associations and other actions that contribute to positive social capital are growing in all three countries. The better people understand the benefits of openness and the long-term costs of particularism, the more easily they can change those negative behaviours.

Kenyan and Ugandan investment promotion efforts need to recognize the role of Indians, and look for positive synergies. To a lesser extent the same is true of the few remaining white Kenyans. Both of those groups, for their part, need to recognize and stigmatise racist behaviours and unfair economic practices by members of their group. They need to work with Africans in government and the private sector on voluntary programs to increase African business opportunities.

Civic efforts are continuously underway to improve institutions such as the banking, legal, judicial and educational systems. People may not have realized the impact of institutions on investment and economic growth, however. Respect for property rights, sound banking systems, courts, educational and health systems have a hitherto neglected impact on economic growth.

**9) The factors above provide a framework for monitoring by each country.**

Instead of relying on low-level investment promotion units to market their countries, governments need to do regular self-evaluations, based on internal and external dialog and monitoring. Evaluations can be led by groups like the Presidential Forum in Uganda. Similar task forces can be created in each country. They should report at least quarterly to

government on how the country ranks in each area. Each report should conclude with recommended policy priorities and adjustments to implementation where needed.

In practice, the main theme of investors invited to dialog with the government is often protection from competition. Both the members of monitoring forums and the personnel of economic ministries need to be continuously reeducated to recognize investors pleas for protection of special interests, consider the trade-offs and favor policies designed to foster competitive firms in a dynamic economy.

**10) When countries are prepared to give investors access to resources, and have their macro economic policies, infrastructure, institutions and security situation in order, proactive investment marketing pays off.**

Investment promotion funding prior to government getting the other factors right has less impact. Kenya and Uganda have seen much of their expenditure on investment promotion unproductive in the last two decades, largely because promotional efforts are working at cross purposes to other policies and practices.

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